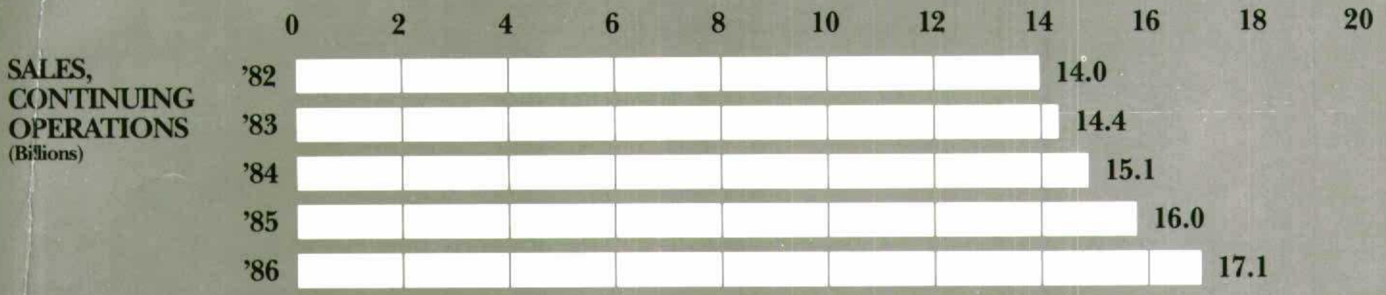
1986

THE KROGER CO. ANNUAL REPORT


SALES, CONTINUING OPERATIONS
(Billions)
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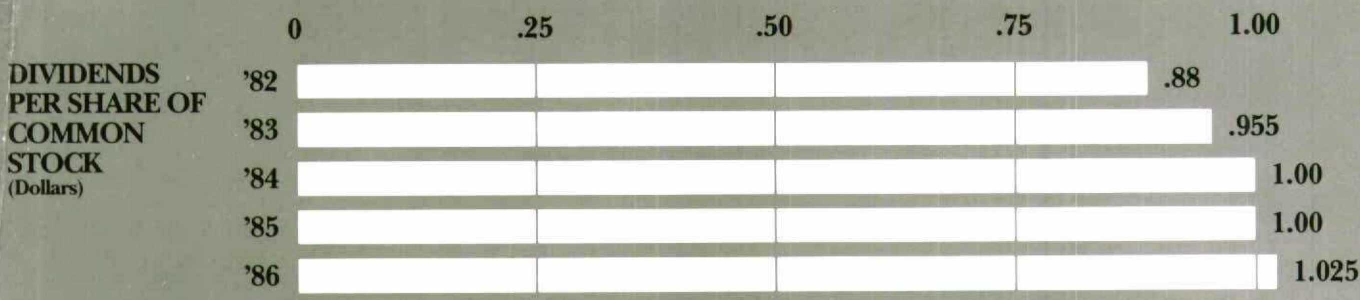
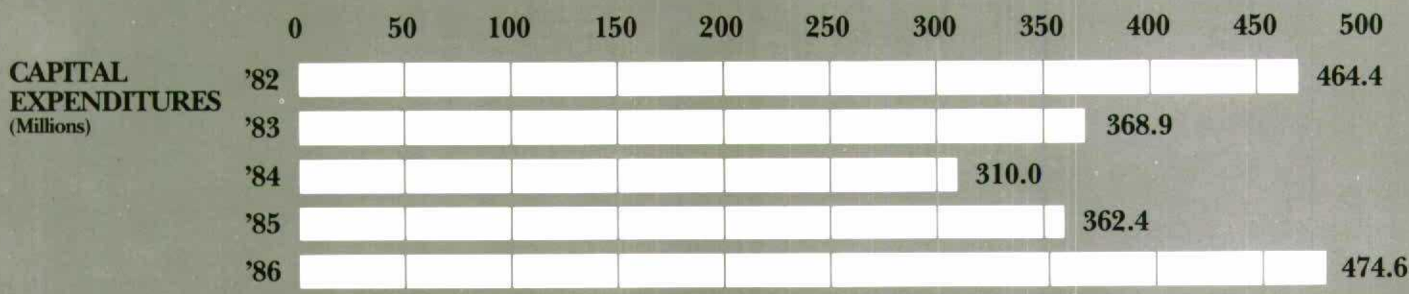
'82 14.0
'83 14.4
'84 15.1
'85 16.0
'86 17.1


DIVIDENDS PER SHARE OF COMMON STOCK
(Dollars)
0 .25 .50 .75 1.00
'82 .88
'83 .955
'84 1.00
'85 1.00
'86 1.025


CAPITAL EXPENDITURES
(Millions)
0 50 100 150 200 250 300 350 400 450 500
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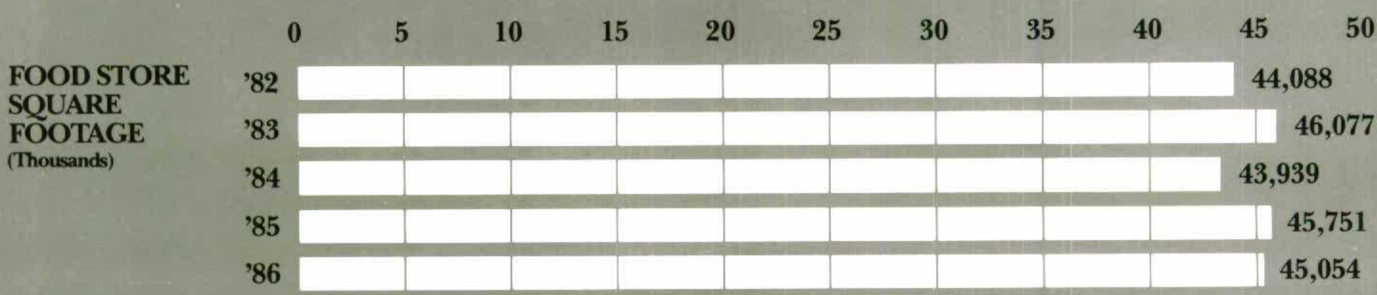
'83 368.9
'84 310.0
'85 362.4
'86 474.6


FOOD STORE SQUARE FOOTAGE
(Thousands)
0 5 10 15 20 25 30 35 40 45 50
'82 44,088
'83 46,077
'84 43,939
'85 45,751
'86 45,054

KEY EVENTS OF 1986 AND THEIR IMPACT ON FINANCIAL RESULTS

A Kroger's sales increase was achieved despite low food inflation and fewer food stores. Because the Company has disposed of its drug stores, their sales are not included in the totals for either 1986 or 1985.

B The restructuring plan implemented by the Company in late 1986 had a dramatic effect on overall results. The plan involved the following actions:

- Closed 100 unprofitable food stores
- Cut corporate expenses through a voluntary early retirement program
- Sold underproductive manufacturing facilities

In sum, the restructuring plan resulted in an after-tax charge of $82.3 million, or 95 cents per share.

The Company established a charitable foundation to take advantage of changes in federal tax laws. This action reduced earnings per share by 12 cents.

Changes in federal tax laws, notably the elimination of investment tax credits, negatively affected per share earnings by approximately 15 cents per share.

Kroger's debt was reduced by approximately 18%.

C Kroger raised its dividend by 5% in July, 1986, and split its common shares on a 2 for 1 basis.

D The divestiture of the Company's 870 drug stores and other assets being sold will generate approximately $500 million in cash. A majority of the proceeds are being used to repurchase 10 million shares of Kroger's common stock.

For further details concerning these events, please turn to the management's discussion on pages 16-17, and the financial data on pages 18-31.


City Market
Kroger
DONNA BUTLER
HEAD DELI CLERK
THE KROGER CO.

Financial Highlights

		1986 (53 weeks)	1985 (52 weeks)
A	Sales from continuing operations	**$ 17.1 billion**	$ 16.0 billion
	Sales increase over prior year	**7.2%**	6.0%
	Food inflation rate	**2.7%**	2.1%
	Sales per average square foot, food stores	**$ 360**	$ 347
B	Earnings from continuing operations		
	Before special charge	**$ 138.1 million**	$ 159.6 million
	After special charge	**$ 55.8 million**	$ 159.6 million
	Earnings per common share, from continuing operations *		
	Before special charge	**$ 1.55**	$ 1.81
	After special charge	**$ .60**	$ 1.81
	Return on average equity		
	Before special charge	**12.4%**	15.5%
	After special charge	**4.4%**	15.5%
C	Dividend rate at year-end per common share *	**$ 1.05**	$ 1.00
D	Common stock price at year-end *	**$ 30.13**	$ 24.06
	Capital expenditures	**$ 474.6 million**	$ 362.4 million
	Real estate data:		
	Food stores		
	Opened and acquired	**62**	68
	Total at year-end	**1,298**	1,367
	Convenience stores		
	Opened and acquired	**104**	220
	Total at year-end	**735**	643

* Adjusted to reflect 2 for 1 stock split in 1986.

To our fellow shareowners

The Kroger Co. is a fundamentally *stronger* retailing organization in 1987.

The Company's restructuring, in which approximately 12% of our asset base was disposed of or sold, has had several beneficial effects. The disposal of 100 unprofitable supermarkets stemmed a cash flow drain and freed management to direct attention toward profitable activities. The sales of SupeRx drug stores and Hook Drugs, Inc., generated proceeds which have been used to reduce debt and to increase shareholder value through stock buybacks. Expenses were reduced through early retirement programs and administrative consolidations. And perhaps most important, our primary mission—the profitable operation of convenience-oriented retail stores—stands today in sharp focus.

1986 RESULTS

Kroger had a solid performance in 1986, especially in the fourth quarter. Annual sales totaled $17.1 billion, a 7% increase over 1985 (excluding results from the retail drug stores). Pre-tax earnings from continuing operations of $279.6 million—excluding the special charge for restructuring and a one-time charge for the creation of a charitable foundation—were slightly ahead of 1985 pre-tax earnings of $277.0 million. With the charges included, net income was reduced to $51.5 million, compared with $180.8 million in 1985. These results also show the impact of the loss of investment tax credits due to changes in federal tax law.

Our supermarkets and convenience stores, as well as Kroger Manufacturing, all showed increases in earnings excluding special charges. Kroger's joint wholesaling and membership warehouse ventures generated sales ahead of expectations.

There were trouble spots, however. The energy-dependent economy of the Gulf Coast depressed retail results in Texas, while aggressive competition dampened earnings in several vital markets.

Progress in labor settlements helped make us more competitive in a number of markets during 1986. But we still operate in many cities where our cost structure puts us at a competitive disadvantage.

STRATEGY AND PRINCIPLES

Kroger's strategy of *"flexible responsiveness"* is supported by several operating principles which lie behind the key management decisions of this decade and this year.

Flexible responsiveness means adapting rapidly and effectively to changes in the operating environment, including demographic, life style, technological and distribution opportunities.

Today the strategy finds expression in our emphasis on *convenience-oriented retailing*. Shoppers are hard-pressed for time. They respond to retailers who deliver one-stop shopping convenience. Our combination stores do just that, offering shoppers more than 20,000 food, drug and general merchandise products—all under one roof.

As we implement flexible responsiveness, Kroger is guided by these basic principles:

- Consumer-driven marketing
- Contemporary facilities and ideas
- Disciplined asset review
- Rigorous cost control
- Increasing shareholder value

Consumer-driven marketing—A basic merchandising goal of the Kroger Food Store group centers on achieving "Superior Merchant" status. The goal derives from consumer rankings of features that shoppers desire in their supermarket, such as service, variety and expanded perishables departments.

Contemporary facilities and ideas—Counting remodels and expansions, approximately 74% of the stores Kroger operates today are less than six years old.

Kroger merchandisers, meanwhile, continue to explore new sources of sales and profits *within* the food store. In 1986, the Company expanded its activities in such contemporary businesses as video rental, fully-cooked meats and home floral delivery. We also began testing customer-operated scanner checkout.

Disciplined asset review—Key to restructuring is Kroger's commitment to analyze continuously the performance of all corporate assets.

The sales of the unprofitable food stores and the retail drug business were direct outgrowths of this asset management process. By the same token, in early 1987 we acquired 18 combination stores in Florida, adding strength to our asset base in a fast-growing market. Our convenience store business is expanding because of its higher return on assets.

Rigorous cost control—During 1986, important lower-cost labor contracts were signed in Houston, Cincinnati and several other major markets. We also eliminated cost-of-living adjustments from most of our existing contracts and largely eliminated double time on Sunday.

Increasing shareholder value—Kroger stock appreciated in value by 25.2% in 1986. In mid-year, the annual dividend was increased 5% and the stock was split. The Company is also repurchasing up to 10 million shares of Kroger stock, which will enhance per share earnings in 1987.

1987 OUTLOOK

With restructuring behind us, we will devote full attention to improving our standing relative to our strongest competitors, as measured by return on assets and return on equity.

Because inflation remains low, retailers can grow only by aggressive, creative merchandising coupled with disciplined cost control.

For Kroger, that means developing our existing strengths. As we continue to expand our combination store emphasis, we also are updating the "look" of the stores. New models opening in 1987 will be contemporary in lighting, colors and overall design. They will feature significantly upgraded presentations of perishables, including deli, bakery and produce. Such highly successful programs as *"Meat Excellence"* will continue, and we will place additional emphasis on expanding in-store service.

At the same time, we will review our asset base on a systematic basis, making changes when necessary. For example, we have begun using the services of outside wholesalers to reduce expenses in certain markets in Texas and Florida.

Joseph A. Pichler, ***President & Chief Operating Officer;*** **Lyle Everingham,** ***Chairman & Chief Executive Officer***

In 1987, we plan to build 65 new stores and remodel or expand another 100. We will also actively look for acquisitions that complement the markets we serve.

Kroger's test of the superwarehouse format is beginning this spring with the opening of our first *Welcome* store in Greenville, S.C. Our *Price Savers Membership Warehouse* division will expand further in the Los Angeles area and also enter Cincinnati.

With such an array of store formats Kroger will have additional flexibility in merchandising and distribution to serve our markets with a *combination* of formats.

Internally, we look for a period of stability. As an increasingly decentralized organization, we must encourage diversity so that new ideas can be tested at all levels of the Company. We

also must give our employees a stronger sense of community within the total organization.

These goals are being addressed in a number of ways. Employee committees at the store level serve as forums for new ideas. Internal communications have been expanded and upgraded.

Employee stock ownership is also being encouraged. Already, 96,000 Kroger employees are enrolled in a payroll deduction plan for the purchase of Company stock. We will continue offering shares as recognition for superior performance as well as an alternative form of compensation in some contract negotiations.

CORPORATE RESPONSIBILITY

Kroger's outside corporate activities brought extensive public recognition in 1986, both nationally and in the hundreds of cities and towns where our employees work and live.

Kroger Food Stores and *King Soopers* each received Distinguished Public Service Awards from President Reagan in 1986 for community service activities. Kroger was honored for its efforts to raise money and food for the nation's hungry, while *King Soopers* was recognized for its efforts to assist the elderly with food shopping.

Kroger's 1986 contributions to non-profit causes, including cash and product donations to support local community undertakings, totaled $3.6 million.

To take advantage of favorable changes in tax legislation, as well as to improve the coordination of the Company's wide-ranging charitable activities, Kroger has created a charitable foundation with $20 million in funds. The foundation will handle approximately 80% of requests received each year. The after-tax cost of future donations will be substantially reduced by this action.

Two members of Kroger's Board of Directors have resigned. William G. Kagler, a member since 1982, and Philip E. Beekman, who joined the Board in 1978, provided wise counsel, sound business judgment and outstanding professional service.

SUMMARY

A company like Kroger can never be satisfied with the *status quo*.

The restructuring decisions implemented in 1986 were, in part, a response to changes in the *external* operating environment that is transforming broad segments of American business and industry.

To remain independent, Kroger must constantly improve its posture as an innovative, profitable enterprise. This can only be achieved through timely assessments of our asset base and management decisions. It also requires a willingness to make difficult and, at times, painful decisions.

Restructuring was a significant change in the *status quo* of the Company. But it has reinforced Kroger's ability to operate in the best *long-term* interests of our customers, our shareholders and our employees.

We believe 1987 will be a year of significant progress, both in increasing sales and profits, and also in our ability to continue meeting the needs of the American consumer. It is the one constant we are dedicated to preserving.

Lyle Everingham

Lyle Everingham
Chairman & Chief Executive Officer

Joseph A Pichler

Joseph A. Pichler
President & Chief Operating Officer

March 27, 1987

BUSINESS REVIEW

Food retailing in America is as competitive as ever.

There are more than 154,000 grocery stores in the United States. The diversity in formats and merchandising approaches challenges the imagination.

What will it take for Kroger to stand out in this crowded, fast-changing environment?

For our Company, the question carries a renewed importance in the closing years of the 1980's. The quality of the decisions guiding the operation of Kroger's 1,298 food stores and 735 convenience stores will have a lasting impact on the profitability of the total Company for years to come.

In the following section, Kroger managers and executives discuss the essential elements they believe will insure the organization's preeminence in food retailing.

RESPONSIVENESS TO CUSTOMERS

"Customers today demand a combination of advantages when they shop for groceries," says Joe Pichler, President of The Kroger Co. "They're looking for convenience, price, variety, service . . . and they want it *all.*"

A food store that responds to all these needs is likely to be profitable. But what does being "responsive" mean?

One thing it means is *location*. Today, choosing a site for a new 60,000 square foot combination store involves a blending of sophisticated research tools and the experience of teams of Kroger real estate professionals.

It's not simply a matter of finding vacant land in a heavily populated area, says Larry Kellar, Group Vice President. "Because the average food store investment today is $5 million to $6 million or more, we've got to have a pretty good understanding *beforehand* that each project is going to make money."

How? Kroger combines several analytical disciplines to construct projected sales models for each new store project. These models judge potential store performance based upon such variables as the size of the potential trade area and the number and strength of nearby competitors. They also help determine the appropriate "mix" of merchandise.

Another facet of responsiveness is *convenience*—a blend of factors which make shopping easier and faster. Kroger has long predicated its merchandising strategy on the notion of "one-stop" shopping. But in today's environment, convenience has taken on added significance.

"People today just don't have the time to go from one store to another to buy all the things they need for their families or for themselves," explains Dick Bere, a 30-year Kroger veteran who currently is Vice President of the Company's Southland Marketing Area in Nashville, Tenn. "To the extent that we can offer a facility which responds to a majority of their needs, we can measure our progress in sales and earnings."

Shopping convenience explains Kroger's rapid deployment of combination food and drug stores, of which more than 275 have been built in the past five years. Inside, Kroger is adding dimension to the convenience idea with everything from in-store pharmacies and video rentals to pizza shops, salad bars and home floral delivery.

An important new trend in convenience, notes Dick Koster, Executive Vice President in charge of merchandising and Kroger Manufacturing, is the growing market overlap of food stores and restaurants.

"Convenience for many people today means having their meal prepared for them, whether they actually eat it at home or away," Koster explains. "That's an enormous market for the restaurant and fast-food business, but there's no reason Kroger can't fit in, too. In fact we already

are, with salad bars, pre-cooked meats, fully-prepared gourmet dinners and many, many other items."

Koster believes that food store merchandising strategies can be tailored to better respond to the growing customer preference for prepared meals. "What it takes, basically, is thinking more about the needs of the end-user—the customer—and then coming up with responses that make sense from a price standpoint and from the convenience aspect."

Kroger merchandisers believe convenience will continue to be the dominant consumer trend well into the next century.

"If you listen carefully to what customers say they want when they shop, the conclusion is pretty clear," says Dave Dillon, President of Dillon Companies in Hutchinson, Kansas. "In a very real sense, food retailers today are offering people *time.*"

VARIETY OF APPROACHES

Yet another facet of responsiveness is *variety.* When Kroger merchandisers talk about variety, they're talking about trying to respond to the broadest possible cross section of the shopping public.

"In today's market, there's no such thing as a standard offering, or a typical selection," says Ted Engel, Vice President of Kroger's Central Marketing Area in Indianapolis. "We're responding to customer tastes with products and services—like fresh-cut flowers—that didn't even exist a few years ago."

Food processors, eager to develop markets among fickle shoppers, have introduced more than 6,300 new grocery items between 1980 and 1985. In perishables, the story is much the same. Due largely to a growing awareness of nutrition, per capita consumption of fresh produce has increased 12% in just a decade. A significant portion of this growth has come about as a result of the marketing of heretofore unknown or exotic fruits and vegetables.

Another is seafood, a market Kroger pioneered. In little more than five years, the varieties of fish sold in Kroger seafood shops has risen from 20 to 72. For some species, like Alaskan salmon and New Zealand Orange Roughy, Kroger helped create the domestic market.

"If you had asked me five years ago about Orange Roughy, I wouldn't have known what you were talking about," says Joe Fey, Manager of Seafood Merchandising & Procurement. "Today, because customers like it so much, Orange Roughy is a staple in the seafood shop . . . there's no telling which kind of fish you've never heard of we will be selling next year."

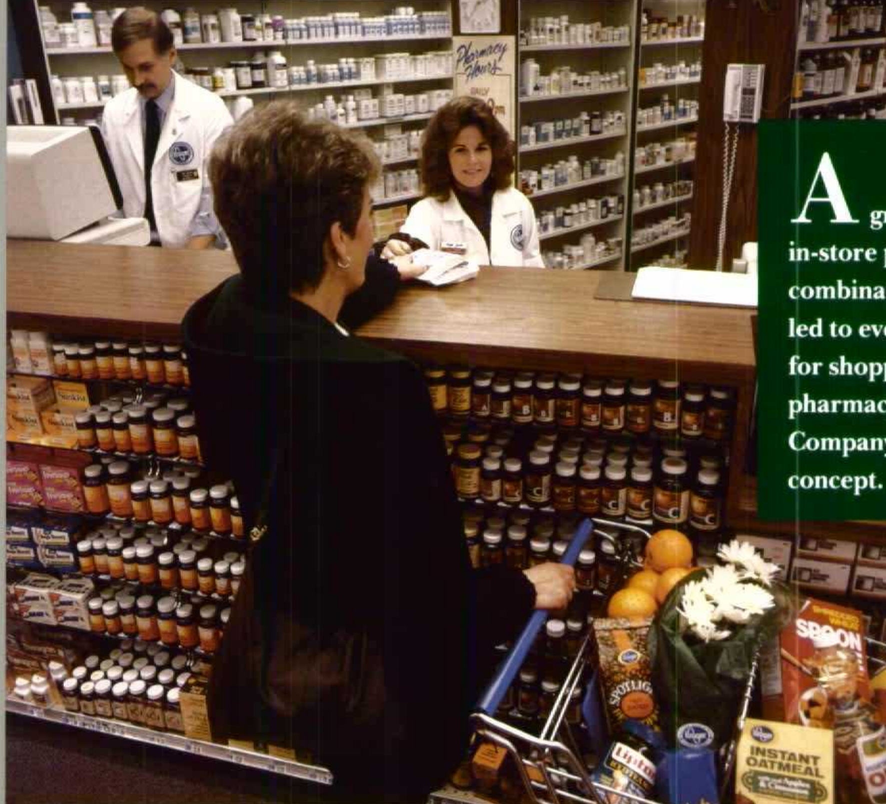
The key to expanding variety, says Don Gallegos, Senior Vice President, Dillon Companies, is being customer-oriented and driven by merchandising. "Our real opportunity as retailers is to challenge the thinking of consumers and satisfy their shopping choices through our merchandising efforts," Gallegos says.

THE ABILITY TO BE DIFFERENT

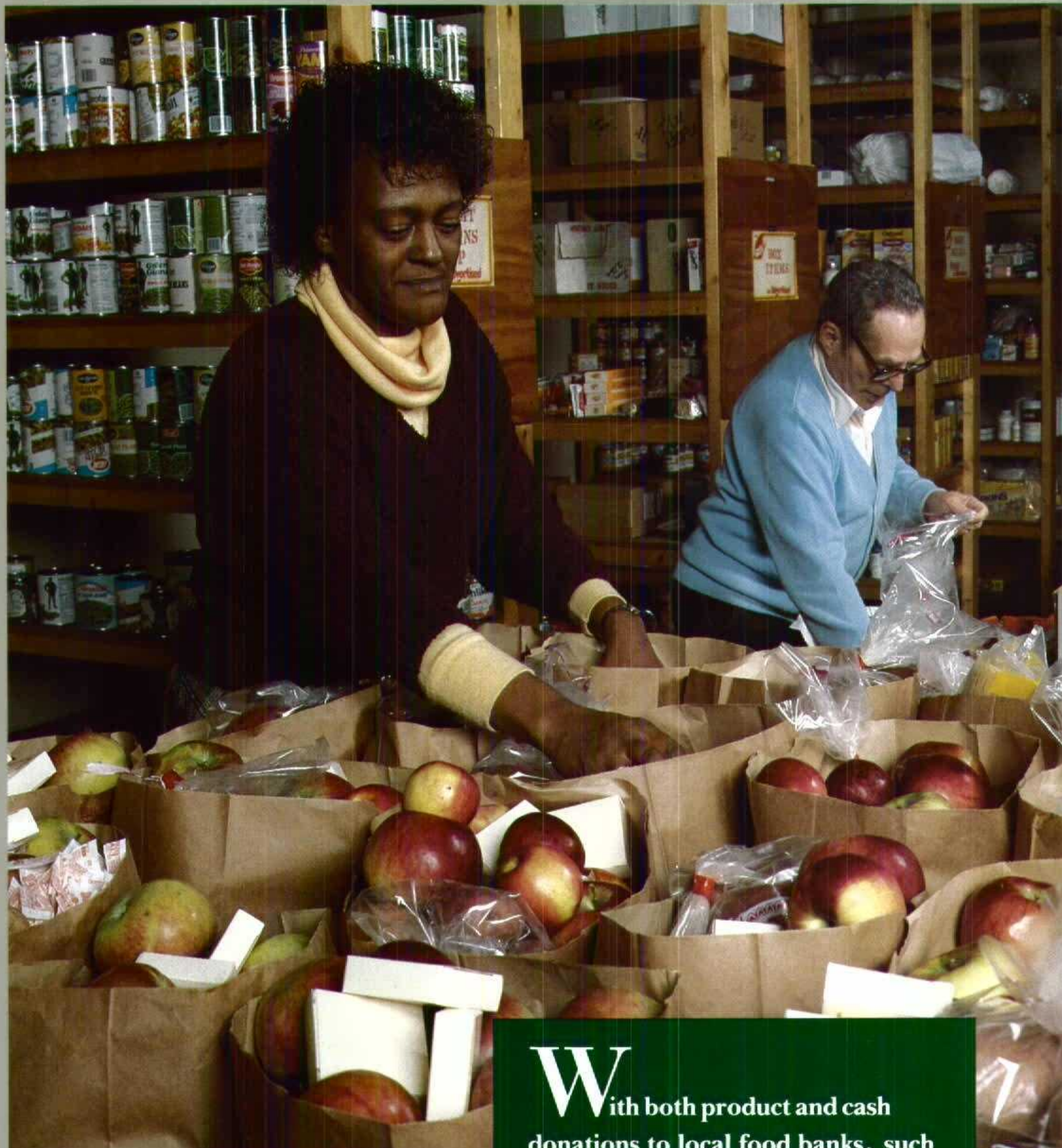
On a Navaho Indian reservation in New Mexico, *City Markets* operates a 41,800 square foot superstore. Near downtown Atlanta, *Kroger* is building a 54,000 square foot combination store, while in nearby Greenville, S.C., the first *Welcome* super warehouse store opens this spring. And in the quiet solitude of the south-central Pennsylvania countryside, a *Turkey Hill Minit Market* provides a convenient place for a shopper to pick up a few grocery items, plus an ice cream treat.

These differing store formats make an important point about the retail environment of the late 1980's: successful operators must cater to specific trade areas and consumers with varying tastes and shopping patterns.

Some traditional customer values never change. Fresh produce is always a primary attraction to shoppers and a continuing strength of the Kroger food store. Kroger's reputation in perishable products is a cornerstone of the Company's merchandising strategy.



A growing commitment to in-store pharmacies in the combination store format has led to even greater convenience for shoppers. A full service pharmacy is an integral part of the Company's one-stop shopping concept.



With both product and cash donations to local food banks, such as the Cincinnati Free Store pictured here, Kroger is helping in the fight against hunger in America. In return, the Company enriches the quality of life in the communities it serves.

Kroger's food distribution system provides the Company with unmatched operating efficiencies. Kroger trucks roll day and night to ensure freshness and quality in products.

Everything for this young couple's dinner—the pre-cooked Cornish game hen, the fresh salad, the salad dressing, the wine and the floral arrangement—was purchased on the way home from work at a Kroger Food Store. Together, they provide a high-quality meal for people too busy to prepare it themselves.

For a company as large and as far-flung as Kroger, that means being different. Yet that's not as easy as it sounds in this age of "economies of scale" and mass production redundancy.

Kroger managers think diversity in format and merchandising strategy is a critical element for long-range success. Kroger enters 1987 with modern facilities ranging from very small (2,400 square feet) convenience stores to the very large (100,000 square feet) *Price Savers Membership Warehouse.*

But categorizing formats can be misleading because retailers are offering all varieties of service and features. The result is a richly diverse competitive environment featuring many *hybrid* formats and merchandising programs.

Even the familiar convenience store is changing. Already the fastest-growing segment of the retail food industry, convenience stores are adding sit-down restaurant areas and prepared convenience food items. "Many people who work outside the home eat their meals on the run, or whenever they have a spare moment," says Frank Remar, Senior Vice President of Dillon, responsible for the convenience store group. "It's a natural evolution of our marketing strategy to respond to this need within our current formats."

Operating many different kinds of stores reflects Kroger's willingness to test any configuration and merchandising strategy that may prove profitable, says Pat Kenney, Vice President of the Texas Marketing Area in Houston. "I don't think anyone at Kroger has ever been satisfied for very long with *one* format or *one* merchandising strategy—but neither is anyone interested in a total overhaul from one approach to another. It has to be a mix, and we have to be willing to look at different ideas for store layout and everything we put into the store," Kenney says.

SHARED DECISIONS

Having the ability to be different implies something else: making key decisions in response to different—and changing—market conditions.

Walter Dryden, Senior Vice President, and a 35-year Kroger veteran, recalls that for many years, *uniformity* in merchandising, format and the other basics of the business was thought to be the basis for profitable growth.

Today's market requires a much more open and free-flowing organization, Dryden says. "Internally, we have to be mentally prepared for independent thought."

Much of what is driving Kroger today is a vigorous push for more widespread and shared decision-making; that is, decisions which are made *closest* to the customer. It is expected that broadened responsibility will create a variety of marketplace responses more in tune with today's fast-changing retail environment.

"When you disperse decision-making, you're really freeing up the creative energy of an organization," says Don Becker, Director of Operations in the Cincinnati-Dayton Marketing Area. "By placing responsibility closer to the point of contact with the customer, you encourage employees to see the customer's needs without a whole lot of filters. It helps you see better."

An important effect of dispersed decision-making is its impact on employee attitudes, especially as those attitudes affect Kroger's stated goal of becoming a "superior merchant."

"A fundamental way to promote positive attitudes is to give an employee a sense of confidence and self-worth," explains Kathy Miller, Manager of Human Resources for the Kroger Marketing Area in Louisville. "Real job responsibility, and the sense that, 'yes, what I do *does* count,' accomplish that better than anything else."

But Kroger is doing something besides sharing decision-making. It is also looking for employees with leadership skills and the ability to cause change. Says Miller, "We want people

who can *motivate* and people who aren't afraid to respond to ideas wherever they originate. The more of those kind of people we have, the more open and sharing the total organization will become."

COSTS THAT MAKE SENSE

Kroger managers identify one other essential element for retailing success: the insistence on *controlling costs.*

Grocery store profits generally average only about 1% of sales, so cost containment has always pervaded management thinking. But in a time of low inflation, and in the midst of a basic realignment of assets not only in the supermarket business, but American industry in general, Kroger's recent actions demonstrate a renewed emphasis on cost containment.

"It isn't simply a matter of negotiating for less costly labor contracts—although that is clearly a continuing priority," says Tom Murphy, Group Vice President of Human Resources and Labor Relations. "We see it as more of a mind-set to keep looking at how we are organized to do business, to identify things we can do better and cheaper."

One example: Kroger's move into wholesaling. The Company has a vast and efficient warehousing and distribution system that has been an integral part of Kroger from the beginning. Yet in certain markets, Kroger is exploring whether it can bolster return on assets by using the services of outside wholesalers. In Texas, Kroger has joined with Fleming Cos., a leading food wholesaler, to service Kroger Food Stores in San Antonio. Another wholesaler co-op is supplying the Company's *Florida Choice* stores. Meanwhile, Kroger's joint venture in Michigan, *Foodland Distributors,* is providing the Company with a detailed, first-hand look at the wholesaling business.

Costs also have been trimmed through consolidations of data processing and accounting staffs in the field, and through voluntary early retirement programs—all of these steps *in addition to* the closing of 100 unprofitable food stores in 1986 alone.

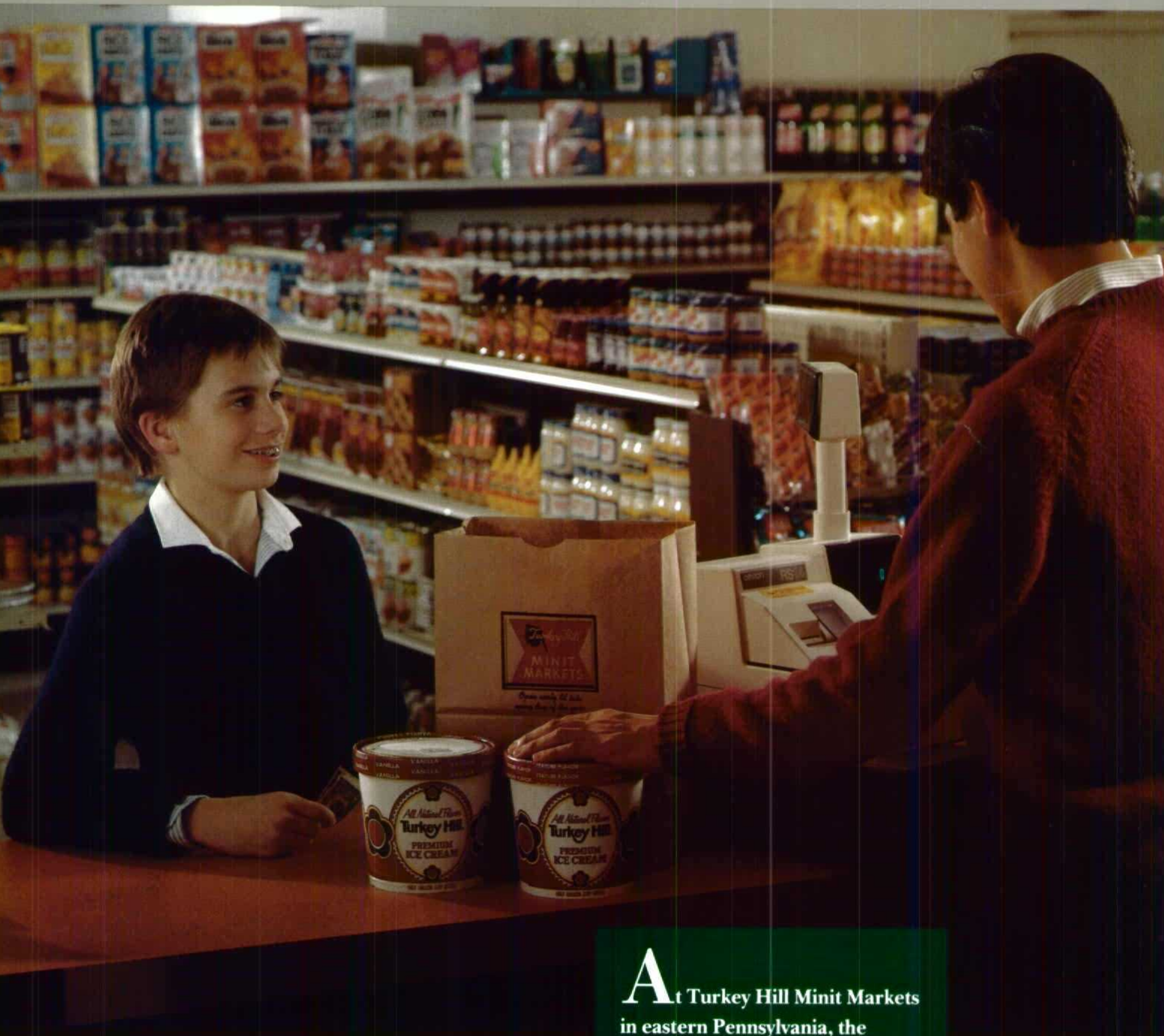
Still, it is labor costs that are the continuing focus of attention. Murphy sees the challenge as evening out a serious imbalance of wage costs in a number of Kroger markets, and at the same time building among Kroger employees a sense of "mutual self-interest, so that it's not us against them, but *all* of us working together for goals which help everyone."

An encouraging note in this regard: employees are buying into the business. More than 96,000 Kroger employees are also shareholders, the result of a payroll deduction plan and a variety of incentive programs.

What do all these elements add up to? In Lyle Everingham's opinion, they mean having an organization that is always capable of dealing with change.

"What is underway within Kroger is a microcosm of changes affecting the entire American economic sector," Everingham says. "We've had to cut costs severely . . . we've had to re-think the deployment of our asset base . . . we've had to make difficult decisions concerning stores and people. And in the midst of all that, we've had to continue serving the millions of customers who rely on us every day. 1986 was a year of great change, but by dealing with change now, we're in good shape for the future."

Opportunities in the Southwestern Sun Belt are greater than ever. Fry's Food Stores of Arizona is taking advantage of that growth in the Phoenix and Tucson markets with new facilities like this combination store in suburban Phoenix.



At Turkey Hill Minit Markets in eastern Pennsylvania, the typical selection of convenience store items is augmented by fresh, premium quality ice cream and dairy products from the Turkey Hill Dairy.

MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING

The consolidated financial statements of The Kroger Co. and Consolidated Subsidiary Companies and other financial information contained in this report were prepared by management, which is responsible for their integrity and completeness. These statements were prepared in conformity with generally accepted accounting principles and necessarily include some amounts that are based on management's best estimates and judgments.

The Company has, over the years, maintained a system of internal accounting controls to provide reasonable assurance that Company assets are adequately protected, and that transactions are executed in accordance with management's authorizations and are reflected accurately in the Company's books and records as a basis for the reliable preparation of the financial statements. The system of controls includes careful selection and training of financial management personnel, clearly defined limits of authority and division of responsibility, the dissemination of detailed formal accounting and business policies and procedures, and an extensive program of internal audit examinations to monitor the effectiveness of the system. The Company has distributed to key employees its policy requiring high moral, ethical and legal standards in the conduct of its business.

Coopers & Lybrand, independent certified public accountants, have examined the consolidated financial statements in accordance with generally accepted auditing standards. Their report on the consolidated financial statements appears on this page.

The Board of Directors, acting through its Audit Committee comprised entirely of outside directors, oversees the fulfillment by management of its responsibilities in the preparation of financial statements and for financial control. The Committee recommends the selection of the Company's independent certified public accountants, reviews the scope and cost of the internal and external audit programs, and meets formally at least twice per year with the internal and external auditors, providing them direct free access at these and other times.

REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

To the Shareowners and Board of Directors
The Kroger Co.

We have examined the consolidated balance sheets of The Kroger Co. and Consolidated Subsidiary Companies as of January 3, 1987 and December 28, 1985, and the related consolidated statements of earnings and accumulated earnings and changes in financial position for the years ended January 3, 1987, December 28, 1985 and December 29, 1984. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the consolidated financial position of The Kroger Co. and Consolidated Subsidiary Companies as of January 3, 1987 and December 28, 1985, and the consolidated results of their operations and the changes in their financial position for the years ended January 3, 1987, December 28, 1985 and December 29, 1984, in conformity with generally accepted accounting principles which, except for the change, with which we concur, in the method of accounting for pension costs as described in Notes to Consolidated Financial Statements, have been applied on a consistent basis.

Coopers + Lybrand

Coopers & Lybrand
Cincinnati, Ohio
February 27, 1987

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Results of Operations

While pre-tax operating results of the Company's continuing operations, before nonrecurring charges, were ahead of 1985, the reported results were significantly reduced by a special charge for corporate restructuring and a one time charge for the creation of a charitable foundation. In addition, since the Company was in the process of selling its drug stores, this segment of business is reported as discontinued operations. The following table reflects the primary components of the 1986 results as compared with 1985 and 1984:

(In millions)	1986	1985	1984
Sales from continuing operations	**$17,123**	$15,967	$15,063
Percent change	**+7.2%**	+6.0%	+4.3%
Pre-tax earnings from continuing operations before nonrecurring charges	**$ 279.6**	$ 277.0	$ 239.6
Percent change	**+1.0%**	+15.6%	+29.0%
Nonrecurring charges			
Corporate restructuring	**(164.0)**		
Charitable foundation	**(20.0)**		
Pre-tax earnings from continuing operations	**95.6**	277.0	239.6
Percent change	**-65.5%**	+15.6%	+29.0%
Income taxes			
Before nonrecurring charges	**(131.5)**	(117.4)	(96.4)
Due to nonrecurring charges	**91.7**		
	(39.8)	(117.4)	(96.4)
Earnings — continuing operations	**55.8**	159.6	143.2
Percent change	**-65.0%**	+11.4%	+26.0%
Discontinued operations	**(4.3)**	21.2	13.4
Net earnings	**$ 51.5**	$ 180.8	$ 156.6
Percent change	**-71.5%**	+15.4%	+23.3%

Consolidated sales of $17.1 billion for the 53 week 1986 year were 7.2% ahead of 1985 despite the closing of over 100 supermarkets during the year. Without the 53rd week in 1986, the sales increase would have been 5.2%.

	1986		1985		1984	
	Amount	**Change**	Amount	Change	Amount	Change
Food stores	**$16,273**	**+ 6.5%**	$15,273	+ 5.5%	$14,473	+ 3.9%
Convenience stores	**480**	**+18.8%**	404	+29.9%	311	+19.6%
Other	**370**	**+27.9%**	290	+ 3.4%	279	+ 9.4%
Total	**$17,123**	**+ 7.2%**	$15,967	+ 6.0%	$15,063	+ 4.3%

The food store sales increase was achieved despite low food inflation, a reduction in store count and a reduction in square footage. While the Company's internal inflation index showed a 2.7% increase in prices, identical store sales increased 1.9% over 1985. Intense competitive activity in several markets and economically depressed Texas/Louisiana operations contributed to the low identical store sales increase for the food stores.

The convenience store sales increase was influenced by the addition of 51 Loaf 'N Jug stores in August of 1986 and by 170 Turkey Hill Minit Market stores in Pennsylvania in August of 1985. Identical store sales for this segment declined by 11.4%. The decline in the retail price of gasoline, which represents approximately 40% of the sales in this segment, caused a 24.4% decrease in identical store gasoline sales.

Merchandise costs, including warehousing and transportation, were 76.9% of sales in both 1986 and 1985, and were 76.8% in 1984. The LIFO charge for continuing operations for 1986 rose to $23.3 million from $2.8 million in 1985 and $24.9 million in 1984. The 1985 LIFO charge was depressed due to the introduction of an aggressive forward buy program which reduced unit costs of inventory.

Operating, general and administrative expense was 18.5% of sales in 1986 compared to 18.3% in 1985 and 18.6% in 1984. While cost containment measures were successful during the year, this 1986 expense rate was influenced by higher insurance costs which caused a .16% increase and by a charitable foundation charge of $20 million which increased the rate by .12%. The charitable foundation was established to take advantage of changes in federal tax legislation. It is anticipated that the foundation will handle approximately 80% of future charitable donations, thereby enhancing Company profits in future years.

The corporate special charge for restructuring of $164 million included the closing of 100 food stores and several manufacturing plants, cost reduction programs, reorganization costs and other charges. The special charge included in continuing operations related to these actions is as follows:

(In thousands of dollars)	
Loss relating to stores closed or sold	**$ 47,123**
Loss relating to manufacturing plants closed or sold	**23,835**
Voluntary retirement program (includes approximately $49.7 million which will be paid from the pension plan)	**63,400**
Reorganization costs and other charges	**29,667**
Total pre-tax special charge	**164,025**
Income tax benefit	**81,725**
Impact on net earnings	**$ 82,300**

The effect of the special charge was 95¢ per share.

Income taxes in 1986 increased approximately $13 million or 15¢ per share due to the loss of investment tax credits eliminated by the Tax Reform Act of 1986. The tax reduction related

to the nonrecurring charges was $91.7 million. The effective tax rate, excluding the impact of the nonrecurring charges, was 47.0% in 1986 compared to 42.4% in 1985 and 40.2% in 1984.

After-tax earnings from continuing operations were $55.8 million in 1986 compared to $159.6 million in 1985 and $143.2 million in 1984. Net earnings were $51.5 million, after loss from discontinued operations, for 1986 compared to $180.8 million in 1985 and $156.6 million in 1984. Earnings per common share declined to $.55 in 1986 from $2.05 in 1985 and $1.74 in 1984.

Earnings per share calculations reflect a two-for-one stock split for common shares distributed on September 30, 1986 to shareowners of record on September 1, 1986 and also reflect preferred stock dividends of $3.3 million in 1986. The average number of shares outstanding was reduced to 86.9 million from 88.3 million in 1985 and 89.9 million in 1984 as a result of the partially implemented plan to purchase up to 10 million shares of common stock.

The Company is concluding the sale of its drug stores in a series of private transactions and has reported the results of these operations as discontinued operations. The after-tax loss of $4.3 million includes operating results through the end of the third quarter, which is deemed to be the measurement date for the disposition of the drug stores, and a $12.1 million special charge for inventory revaluation and underproductive stores. The $4.3 million loss compares to earnings of $21.2 million in 1985 and $13.4 million in 1984. Approximately 670 of 870 drug stores had been disposed of by the end of 1986. Operating results for the fourth quarter of 1986 have been deferred. They will be used in computing the results of the drug store disposition program which is expected to be completed in the first quarter of 1987. The final results of the dispositions are not expected to have a material effect on net earnings.

Liquidity and Capital Resources

The disposition of assets included in the restructuring program and discontinued operations provided more than $500 million in cash during the fourth quarter of 1986. This cash was used to reduce short-term and high cost long-term debt and to purchase shares of common stock ($123 million). In addition, the common stock dividend was increased 5% effective with the September 1, 1986 dividend payment.

During the second quarter of 1986, the Company issued $100 million of 8% notes due May 1, 1993 and $125 million of Auction Preferred Shares. The Company has entered into a ten year interest rate swap to hedge against a precipitous rise in the preferred dividend rate. The proceeds from these transactions were used to reduce short-term debt incurred because of acquisitions and stock repurchases in 1985. Other major financing activities during 1986 included three sale/leaseback transactions totaling $86 million.

Capital expenditures for 1986 totaled $475 million and for the 1984-1986 period totaled $1.15 billion. Acquisitions in 1985 bring the three year total of acquisitions and capital related expenditures to $1.42 billion. Total cash provided from operations during that three year period was $1.21 billion. New store activity for 1986 included 62 food stores, 42 drug stores and 104 convenience stores. Convenience store additions included the acquisition of MarTec Corporation in Pueblo, Colorado, which operates 51 Loaf 'N Jug convenience stores.

Capital expenditures for 1987 will be approximately $450 million, including 65 new stores and the remodeling or expansion of another 100. The Company will finance expansion with internally generated cash flow. Long-term debt will be employed as required and short-term capital needs will be met with commercial paper.

While cash and short-term investments increased to $212 million at January 3, 1987 from $106 million at December 28, 1985 and $163 million at December 29, 1984, total working capital was reduced because of liabilities related to the restructuring program and disposition of the drug stores. Key working capital statistics are as follows:

(In millions of dollars)	**January 3, 1987**	December 28, 1985	December 29, 1984
Cash and short-term investments	**$212**	$106	$163
Notes payable	**$ 10**	$122	$ 4
Working capital	**$178**	$274	$277
Current ratio	**1.1 to 1**	1.2 to 1	1.2 to 1

Long-term obligations, as a percentage of long-term capitalization were:

	Percent of Long-Term Capitalization		
	1986	1985	1984
Senior debt	**29.3%**	33.6%	30.0%
Capitalized lease obligations	**10.3%**	10.2%	10.4%
Total	**39.6%**	43.8%	40.4%

At January 3, 1987, the Company had available a revolving credit aggregating $250 million against which it may obtain interim loans until March, 1991. At the Company's request, any interim loans may be converted into term loans payable over six years.

CONSOLIDATED BALANCE SHEET
(In thousands of dollars)

	January 3, 1987	December 28, 1985
ASSETS		
Current assets		
Cash and temporary cash investments	$ 212,156	$ 105,510
Receivables	264,853	215,414
Inventories:		
FIFO cost	1,435,269	1,696,590
Less LIFO reserve	(238,031)	(223,834)
	1,197,238	1,472,756
Property held for sale	100,891	88,022
Deferred income taxes	27,209	
Prepaid and other current assets	148,384	119,431
Total current assets	1,950,731	2,001,133
Notes receivable	35,878	34,218
Property, plant and equipment		
Land	176,846	147,343
Buildings and land improvements	453,800	461,894
Equipment	1,731,578	1,685,093
Leaseholds and leasehold improvements	480,629	485,389
Leased property under capital leases	260,337	269,430
	3,103,190	3,049,149
Allowance for depreciation and amortization	(1,134,718)	(1,112,228)
Property, plant and equipment, net	1,968,472	1,936,921
Investments and other assets	121,366	205,535
Total Assets	$4,076,447	$4,177,807

The accompanying notes are an integral part of the consolidated financial statements.

	January 3, 1987	December 28, 1985
LIABILITIES		
Current liabilities		
Current portion of long-term debt	**$ 117,215**	$ 35,730
Current portion of obligations under capital leases	**5,825**	5,920
Notes payable	**10,341**	122,170
Accounts payable	**912,371**	986,729
Other current liabilities	**537,196**	487,788
Accrued income taxes	**114,297**	89,124
Accrual for special charge	**75,763**	
Total current liabilities	**1,773,008**	1,727,461
Long-term debt	**561,258**	710,890
Obligations under capital leases	**196,981**	214,586
Deferred income taxes	**292,176**	314,390
Other long-term liabilities	**98,253**	21,810
Total Liabilities	**2,921,676**	2,989,137
SHAREOWNERS' EQUITY		
Preferred capital stock, cumulative, voting, par $100 Issued: 1986 - 1,250,000 Auction Preferred shares, Series A and B 1985 - None	**125,000**	
Common capital stock, par $1, at stated value Issued: 1986 - 97,814,920 shares 1985 - 97,045,616 shares	**409,953**	396,387
Accumulated earnings	**938,752**	980,003
Common stock in treasury, at cost 1986 - 13,750,999 shares 1985 - 9,679,944 shares	**(318,934)**	(187,720)
Total Shareowners' Equity	**1,154,771**	1,188,670
Total Liabilities and Shareowners' Equity	**$4,076,447**	$4,177,807

Consolidated Statement of Earnings and Accumulated Earnings

Years Ended January 3, 1987, December 28, 1985 and December 29, 1984
(In thousands, except per share amounts)
(1985 and 1984 restated for discontinued operations)

	1986 (53 Weeks)	1985 (52 Weeks)	1984 (52 Weeks)
Sales, Continuing Operations	**$17,122,518**	$15,966,620	$15,063,414
Costs and expenses			
Merchandise costs, including warehousing and transportation	**13,170,911**	12,282,282	11,575,943
Operating, general and administrative	**3,163,718**	2,926,489	2,797,674
Rent	**226,070**	202,121	195,774
Depreciation and amortization	**211,159**	194,715	181,996
Dividend and interest income	**(12,744)**	(17,830)	(23,171)
Interest expense	**103,765**	101,862	95,618
Special charge	**164,025**		
Total	**17,026,904**	15,689,639	14,823,834
Earnings from continuing operations before taxes based on income	**95,614**	276,981	239,580
Taxes based on income	**39,846**	117,418	96,382
Earnings from continuing operations	**55,768**	159,563	143,198
Results of discontinued operations	**(4,275)**	21,187	13,435
Net Earnings	**$ 51,493**	$ 180,750	$ 156,633
Accumulated Earnings			
Beginning of year	**$ 980,003**	$ 887,606	$ 820,944
Net earnings	**51,493**	180,750	156,633
Cash dividends on common stock	**(89,428)**	(88,353)	(89,971)
Cash dividends on preferred stock	**(3,316)**		
End of year	**$ 938,752**	$ 980,003	$ 887,606
Earnings Per Common Share			
From continuing operations	**$ .60**	$1.81	$1.59
From discontinued operations	**(.05)**	.24	.15
Net earnings	**$ .55**	$2.05	$1.74
Cash Dividends Per Common Share	**$1.025**	$1.00	$1.00
Average Common Shares Outstanding	**86,871**	88,347	89,866

The accompanying notes are an integral part of the consolidated financial statements.

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

Years Ended January 3, 1987, December 28, 1985 and December 29, 1984
(In thousands of dollars)
(1985 and 1984 restated for discontinued operations)

	1986 (53 Weeks)	1985 (52 Weeks)	1984 (52 Weeks)
Cash Provided (Used) From Operations			
Earnings from continuing operations	**$ 55,768**	$159,563	$143,198
Charges (credits) not involving cash:			
Depreciation and amortization	**211,159**	194,715	181,996
Provision for deferred income taxes	**(39,806)**	35,537	39,152
Increase in pension plan liability	**57,563**		
Earnings (loss) from discontinued operations	**(4,275)**	21,187	13,435
Charges (credits) not involving cash — discontinued operations:			
Depreciation and amortization	**19,852**	14,899	8,668
Provision for deferred income taxes	**(9,617)**	4,277	3,223
Earnings and non-cash charges	**290,644**	430,178	389,672
Other cash provided (used) net of acquisitions and dispositions:			
Decrease (increase) in current cost of inventory	**53,271**	(129,011)	(124,687)
LIFO charge	**30,188**	6,193	29,833
Increase in other current assets	**(98,997)**	(4,575)	(53,564)
Increase in other current liabilities	**166,340**	89,520	139,489
Cash Provided From Operations	**441,446**	392,305	380,743
Cash Provided (Used) Through Financing Activities			
Cash dividends	**(92,744)**	(88,353)	(89,971)
Preferred stock issued	**125,000**		
Common stock issued	**20,896**	116,089	23,575
Capital stock reacquired	**(139,783)**	(175,186)	(15,749)
Increase (decrease) in notes payable	**(111,829)**	110,512	(1,140)
Additions to long-term debt and obligations under capital leases	**170,914**	185,069	36,892
Reductions of long-term debt and obligations under capital leases	**(312,962)**	(58,590)	(136,027)
Net book value of fixed asset disposals	**123,292**	151,559	78,654
Capital expenditures	**(474,627)**	(362,436)	(310,029)
Decrease (increase) in property held for sale	**(12,869)**	(77,298)	94,351
Increase in leased property under capital leases	**(16,379)**	(11,125)	(7,622)
Net cash proceeds from disposal of drug stores	**405,677**		
Amounts assigned for mergers and acquisitions		(259,466)	
Other changes, net	**(19,386)**	19,221	(32,574)
Cash Used Through Financing Activities	**(334,800)**	(450,004)	(359,640)
Increase (Decrease) in Cash and Temporary Cash Investments	**106,646**	(57,699)	21,103
Cash and Temporary Cash Investments			
Beginning of Year	**105,510**	163,209	142,106
End of Year	**$212,156**	$105,510	$163,209

The accompanying notes are an integral part of the consolidated financial statements.

All dollar amounts are in thousands except per share amounts.

Accounting Policies

The following is a summary of certain accounting policies followed in preparing the financial statements.

Principles of Consolidation

The consolidated financial statements include the Company and all of its subsidiaries. The 1985 and 1984 amounts have been restated for discontinued operations. In addition, certain prior year amounts have been reclassified to conform to the 1986 presentation.

Inventories

Inventories are stated at the lower of cost (principally LIFO) or market. Approximately 83% of inventories for 1986 and 87% of inventories for 1985 were valued using the LIFO method. Cost for the balance of the inventories is determined by the FIFO method of inventory valuation.

Property Held for Sale

Property held for sale includes assets that are in the process of being sold, and equipment and other assets of discontinued operations.

Property, Plant and Equipment

Property, plant and equipment are stated at cost. Depreciation and amortization, which include the amortization of assets recorded under capital leases, are computed over the estimated useful lives of individual assets, composite group lives or the initial or remaining terms of leases. Buildings and land improvements are depreciated based on lives varying from 10 to 40 years and equipment based on lives varying from three to 15 years. Leasehold improvements are amortized over their useful lives which vary from four to 25 years. Upon sale, retirement or other disposition of major capitalized assets, the cost and related accumulated depreciation are removed from the accounts with any resulting gain or loss reflected in earnings. Maintenance and repair costs are expensed in the year incurred.

Deferred Income Taxes and Investment Tax Credits

Deferred income taxes are provided for timing differences resulting from inclusion of income and expenses for financial reporting purposes in years other than when recognized for income tax purposes. Long-term deferred income taxes consist primarily of the amount of tax applicable to the excess of depreciation for tax purposes over depreciation used for financial reporting purposes. Current deferred income taxes relate primarily to timing differences between financial reporting and tax on the 1986 special charge.

Investment tax credits are included as reductions of income tax expense in the year in which the credits arise.

Special Charge

In July, 1986 the Company announced its intention to downsize its general office overhead cost, primarily through a voluntary early retirement program, and sell or close approximately 100 food stores and various manufacturing facilities. The components of the special charge from continuing operations are as follows:

Loss relating to stores closed or sold	$ 47,123
Loss relating to manufacturing plants closed or sold	23,835
Voluntary retirement program (includes approximately $49.7 million which will be paid from the pension plan)	63,400
Reorganization costs and other charges	29,667
Total pre-tax special charge	164,025
Income tax benefit	81,725
Impact on net earnings	$ 82,300

In addition, results of discontinued operations reflect a pre-tax special charge of $24,115 for inventory revaluation and underproductive stores. The combined impact of the special charge on net earnings is as follows:

	Continuing Operations	Discontinued Operations	Total
Charge related to food stores	$164,025		$164,025
Charge related to drug stores		$24,115	24,115
Total pre-tax charge	164,025	24,115	188,140
Less income tax benefit	81,725	12,058	93,783
Net reduction	$ 82,300	$12,057	$ 94,357
Per share	$ .95	$ .14	$ 1.09

Discontinued Operations

In 1986, the Company announced its intention to sell its drug store business through a series of private transactions. As of January 3, 1987 sales of 667 of these drug stores had been completed, 658 of which were sold to Hook-SupeRx, Inc. ("HSI"), a privately held company. Philip E. Beekman, Chairman and Chief Executive Officer of HSI, was a member of the Company's Board of Directors until his resignation in early 1987. The total cash proceeds from the 1986 disposals were approximately $415,600. The Company entered into agreements for the sale of the remaining stores in the first quarter of 1987. The final results of the dispositions are not expected to have a material effect on net earnings, and will be reported in 1987 results. Approximately $73,700 of drug store inventory and fixed assets is classified as property held for sale at January 3, 1987.

Operating results of the drug store business are summarized as follows:

	1986	1985	1984
Sales	**$1,263,890**	$1,156,911	$859,477
Earnings (loss) from operations before income taxes	**$ (5,907)**	$ 40,979	$ 25,783
Taxes based on income	**1,632**	(19,792)	(12,348)
Earnings (loss) from operations	**$ (4,275)**	$ 21,187	$ 13,435

Other Current Liabilities

Other current liabilities as of January 3, 1987 and December 28, 1985 consists of:

	1986	1985
Salaries and wages	**$ 179,849**	$ 173,533
Taxes, other than income taxes	**104,090**	99,659
Other	**253,257**	214,596
	$ 537,196	$ 487,788

Taxes Based On Income

The provision for taxes based on income from continuing operations consists of:

	1986	1985	1984
Federal			
Current	**$ 70,410**	$ 60,331	$ 39,234
Deferred	**(39,806)**	35,537	39,152
	30,604	95,868	78,386
State and local	**9,242**	21,550	17,996
Total	**$ 39,846**	$117,418	$ 96,382

Investment and other tax credits reduced the tax provision from continuing operations by $7,674 in 1986, $23,039 in 1985 and $16,811 in 1984.

A reconciliation of the statutory federal rate and the effective rate is as follows:

	1986	1985	1984
Statutory rate	**46.0%**	46.0%	46.0%
State income taxes, net of federal tax benefit	**5.2**	4.2	4.1
Investment and other tax credits	**(8.0)**	(8.3)	(7.0)
Other, net	**(1.5)**	0.5	(2.9)
Effective rate	**41.7%**	42.4%	40.2%

Deferred income taxes from continuing operations included in the Consolidated Statement of Earnings and Accumulated Earnings represent the tax effect of amounts expensed for tax purposes in excess of amounts used for financial reporting, and consist of:

	1986	1985	1984
Depreciation	**$ 26,597**	$36,199	$37,490
Special charge	**(66,360)**		
Compensation related costs	**(3,212)**	(2,713)	2,417
Other	**3,169**	2,051	(755)
	$(39,806)	$35,537	$39,152

Debt Obligations

Long-term debt as of January 3, 1987 and December 28, 1985 consists of:

	1986	1985
Short-term borrowings to be refinanced		$100,000
14⅜% notes maturing in 1991, redeemable at par beginning November 15, 1987	$ 44,825	44,825
12⅜% sinking fund debentures		36,950
11% two-year extendible notes due in 1987	45,700	45,700
9% sinking fund debentures maturing in 1995, with annual payments of $2,500 required from 1990 through 1995	15,715	16,570
8.7% sinking fund debentures maturing in 1998, with annual payments of $3,000 required from 1994 through 1998	17,921	28,499
8½% sinking fund debentures maturing in 2001	3,718	20,370
8% notes maturing in 1993, redeemable at par beginning May 1, 1991	100,000	
4⅛% to 14¼% industrial revenue bonds, with annual payments due in varying amounts through 2022	327,396	365,108
6¾% to 12⅞% mortgages, with annual payments due in varying amounts through 2010	100,521	60,663
5% to 12% notes, with annual payments due in varying amounts through 2011	22,677	27,935
Total debt	678,473	746,620
Less current portion	(117,215)	(35,730)
Total long-term debt	$561,258	$710,890

The aggregate annual maturities and payments of long-term debt for the five years subsequent to 1986 are:

1987	$117,215
1988	$ 21,324
1989	$ 14,837
1990	$ 25,429
1991	$ 18,104

The Company intends to redeem the 14⅜% notes in 1987. Accordingly, these notes are included in the current portion of long-term debt.

Certain industrial revenue bonds and mortgage notes payable are collateralized by property, plant and equipment. Interest expense on approximately 40% of the industrial revenue bonds is based on rates which vary with the prime or other variable rates.

Under certain of the loan agreements, payments of cash dividends are limited. Under the most limiting agreement, accumulated earnings were unrestricted in the amount of $283,000 at January 3, 1987.

The Company periodically engages in short-term borrowing. Short-term borrowing for the three years ended January 3, 1987 was:

	1986	1985	1984
Weighted average for the year	$199,123	$161,658	$ 42,613
Highest level outstanding during the year	$368,676	$383,871	$108,942
Weighted average interest rate	7.14%	8.08%	10.09%

At January 3, 1987, the Company had available a revolving credit aggregating $250,000 against which it may obtain interim loans until March, 1991. The interest rate on the interim loans would be either The First National Bank of Chicago corporate base rate or the LIBOR rate plus ⅝% per annum. The interim loans may be converted into term loans payable over six years. No amounts have been borrowed under this agreement.

Interest costs capitalized in 1986, 1985 and 1984 amounted to $5,747, $3,831 and $2,868, respectively.

Leases

The Company operates principally in leased premises. Lease terms generally range from 10 to 25 years with options of renewal for additional periods. Options provide in some cases for reduced rentals and/or the right to purchase. Certain of the leases provide for contingent payments based upon a percent of sales.

Rent expense from continuing operations (under operating leases) consists of:

	1986	1985	1984
Minimum rentals, net of minor sublease rentals	**$207,897**	$184,511	$178,955
Contingent payments	**18,173**	17,610	16,819
Total	**$226,070**	$202,121	$195,774

Assets recorded under capital leases consist of:

	1986	1985
Distribution and manufacturing facilities	**$110,440**	$110,440
Store facilities	**149,897**	158,990
Less accumulated amortization	**(93,267)**	(85,091)
	$167,070	$184,339

Minimum annual rentals, net of minor sublease rentals, under operating leases for the five years subsequent to 1986 and in the aggregate are:

	Capital Leases	Operating Leases
1987	**$ 29,352**	**$ 201,761**
1988	**29,136**	**199,947**
1989	**29,027**	**195,558**
1990	**28,861**	**188,273**
1991	**28,505**	**181,949**
1992 and thereafter	**337,112**	**1,862,036**
	481,993	**$2,829,524**
Less estimated executory costs included in capital leases	**(33,194)**	
Net minimum lease payments under capital leases	**448,799**	
Less amount representing interest	**(245,993)**	
Present value of net minimum lease payments under capital leases	**$202,806**	

Earnings Per Common Share

Earnings per common share for years 1986, 1985 and 1984 equal net earnings less preferred stock dividends, divided by the weighted average number of common shares outstanding. Preferred stock dividends for earnings per share were $3,316 in 1986. There were no preferred dividends in 1985 and 1984. The effect of common stock equivalents is not significant. Earnings per share amounts have been restated to reflect the September 30, 1986 two-for-one stock split.

Preferred Stock

The Company has authorized 5,000,000 shares of voting cumulative preferred stock, 3,250,000 of which are currently available for issuance. The stock has a par value of $100 and is issuable in series.

On May 28, 1986 the Company issued 625,000 shares of Series A Auction Preferred Shares and 625,000 Series B Auction Preferred Shares at a total price of $125,000. These shares were offered in units of 1,000 and may be redeemed at the option of the Company or on any dividend payment date at one hundred thousand dollars per unit (1,000 shares) plus any accrued dividends. The holders of the outstanding shares are entitled to one vote per share and cumulative dividends which are declared and paid every 49 days. Dividend rates are reset at the dividend payment date (every 49 days) through an auction bidding process. The Company has entered into a 10 year interest rate exchange agreement to hedge against a rise in the preferred dividend rate. At January 3, 1987 the dividend rates for the Series A and Series B shares were 4.59% and 5.00%, respectively. There was no preferred stock outstanding during 1985 and 1984.

Common Stock

The Company has authorized 350,000,000 shares of $1 par common capital stock. On July 18, 1986 the Board of Directors authorized a two-for-one stock split for common shares effective September 30, 1986 to shareowners of record September 1, 1986. Common share amounts have been restated to reflect the split. For the three years ended January 3, 1987, changes in common stock were:

	Issued		In Treasury	
	Shares	Amount	Shares	Amount
December 31, 1983	94,784,286	$357,408	5,294,902	$ 99,203
Exercise of stock options	395,332	3,263	32,606	555
Stock issued in exchange for debt	1,215,828	18,741		
Common stock reacquired			990,000	15,194
Tax benefit from exercise of non-qualified stock options		713		
Dividends reinvested under stock purchase plan	93,628	1,571		
December 29, 1984	96,489,074	381,696	6,317,508	114,952
Exercise of stock options	490,534	4,732	37,194	905
Common stock reacquired			8,402,600	174,281
Stock issued for acquisition		7,525	(5,077,358)	(102,418)
Tax benefit from exercise of non-qualified stock options		1,020		
Dividends reinvested under stock purchase plan	66,008	1,414		
December 28, 1985	**97,045,616**	**$396,387**	**9,679,944**	**$187,720**
Exercise of stock options	**733,007**	**10,300**	**44,351**	**2,232**
Common stock reacquired			**4,436,292**	**137,551**
Stock issued for acquisition		**1,118**	**(409,588)**	**(8,569)**
Tax benefit from exercise of non-qualified stock options		**1,239**		
Dividends reinvested under stock purchase plan	**36,297**	**909**		
January 3, 1987	**97,814,920**	**$409,953**	**13,750,999**	**$318,934**

Stock Option Plans

The Company grants options for common stock under various plans at an option price equal to the fair market value of the stock at the date of grant. In addition to cash payments, the plans provide for the exercise of options by exchanging issued shares of stock of the Company. At January 3, 1987 and December 28, 1985, 3,202,402 and 3,473,028 shares of common stock, respectively, were available for future options. Options may be granted under 1981 and 1985 plans until 1991 and 1995, respectively and will expire 10 years from the date of grant. At January 3, 1987, options on 1,774,513 shares were exercisable.

Changes in options outstanding under the Stock Option Plans of the Company were:

	Shares Subject To Option	Option Price Range Per Share
Outstanding, December 31, 1983	2,976,708	$ 3.89 - $21.22
Granted	209,600	$15.25 - $19.07
Exercised	(395,332)	$ 3.89 - $15.69
Cancelled or expired	(110,148)	$ 3.96 - $20.22
Outstanding, December 29, 1984	2,680,828	$ 4.32 - $21.22
Granted	1,057,046	$19.03 - $22.66
Assumed in acquisition	137,900	$ 8.26 - $13.56
Exercised	(527,654)	$ 4.32 - $19.41
Cancelled or expired	(80,192)	$10.63 - $19.41
Outstanding, December 28, 1985	**3,267,928**	**$ 6.43 - $22.66**
Granted	**240,500**	**$22.35 - $33.75**
Exercised	**(843,781)**	**$ 6.43 - $22.66**
Cancelled or expired	**(14,304)**	**$11.91 - $20.94**
Outstanding, January 3, 1987	**2,650,343**	**$ 6.43 - $33.75**

In addition to stock options, the Company may grant Stock Appreciation Rights (SAR's) to certain officers. In general, the eligible optionees are permitted to surrender the related option and receive shares of the Company's common stock and/or cash having a value equal to the appreciation on the shares subject to the option. The appreciation of SAR's is charged to earnings based upon the market value of common stock. At January 3, 1987, rights related to options for 77,790 shares were outstanding at prices ranging from $11.91 to $21.19 per share.

Also, the Company may grant Restricted Stock Awards to eligible participants. In general, a Restricted Stock Award entitles an employee to receive a stated number of shares of common stock of the Company subject to forfeiture if the employee fails to remain in the continuous employ of the Company for a stipulated period. The holder of an award shall be entitled to the rights of a shareowner except that the restricted shares and the related rights to vote or receive dividends may not be transferred. The award is charged to earnings over the period in which the employee performs services and is based upon the market value of common stock at the date of grant. At January 3, 1987, awards related to 72,800 shares were outstanding.

Warrant Dividend Plan

On February 28, 1986, the Company adopted a Warrant Dividend Plan in which each holder of common stock of record on March 19, 1986 became entitled to one common stock purchase right for each share of common stock owned. When exercisable, the nonvoting rights entitle the registered holder to purchase one share of common stock at a price of $60 per share. The rights will become exercisable, and separately tradeable, ten days after a person or group acquires 20% or more of the Company's common stock, or makes an unsolicited tender offer for 20% or more of the Company's common stock. In the event the rights become exercisable and thereafter the Company is acquired in a merger or other business combination, each right will entitle the holder to purchase common stock of the surviving corporation, for the exercise price, having a market value of twice the exercise price of the right. Under certain other circumstances, including the acquisition of 25% or more of the Company's common stock, each right will entitle the holder to receive upon payment of the exercise price, shares of common stock with a market value of two times the exercise price. At the Company's option, the rights, prior to becoming exercisable, are redeemable in their entirety at a price of $.025 per right. The rights are subject to adjustment to prevent dilution and expire March 19, 1996.

Postretirement Health Care and Life Insurance Benefits

In addition to providing pension benefits, the Company provides certain health care and life insurance benefits for retired employees. The majority of the Company's employees may become eligible for those benefits if they reach normal retirement age while employed by the Company. The cost of retiree health care and life insurance benefits, excluding benefits associated with the Voluntary Retirement Program in 1986, is recognized as expense as claims or premiums are paid. For 1986, 1985 and 1984, the combined cost for those benefits was $3,476, $2,945 and $2,114, respectively.

Pension Plans

In 1986, the Company adopted SFAS No. 87, Employers' Accounting for Pensions, which resulted in a $5,500 increase in net earnings or $.06 per common share. In 1985 and 1984, pension cost was determined under the provisions of APB Opinion No. 8. The provisions of SFAS No. 87 were adopted prospectively, and accordingly, earnings for 1985 and 1984 have not been restated.

The Company administers non-contributory defined benefit retirement plans for substantially all non-union employees. The cost of these plans for 1986, 1985 and 1984 was $1,100, $6,600 and $15,000, respectively. In addition, in 1986 the Company provided special termination benefits of $53,400 which relate to the voluntary early retirement program. Funding for the pension plans is based on a review of the specific requirements and on evaluation of the assets and liabilities of each plan. Employees are eligible to participate upon the attainment of age 21 and the completion of one year of service, and benefits are based upon final average salary and years of service. Vesting is based upon years of service and age.

The Company administered pension benefit obligations were projected to, and the assets were valued as of, the end of 1986. The assets are invested in cash and short-term investments or listed stocks and bonds including $32,700 in common stock of The Kroger Co. The status of the plans at the end of 1986 was:

Actuarial present value of benefit obligations: Vested employees	$309,300
Non-vested employees	10,500
Accumulated benefit obligation	319,800
Additional amounts related to projected salary increases	73,200
Projected benefit obligation	393,000
Assets available for benefits: Funded assets	419,300
Accrued pension expense	74,400
Total assets	493,700
Assets in excess of projected benefit obligation	$100,700
Consisting of: Unamortized net asset existing at date of adoption of SFAS No. 87	(106,900)
Unrecognized net actuarial loss	6,200

Assumptions used to develop the year-end benefit obligations for Company administered plans were a 9% discount rate and a 6% increase in compensation. Assumptions used to develop the 1986 net periodic pension cost were a 10% discount rate, a 10% long-term return on assets and a 7% increase in compensation.

The components of net periodic pension cost for 1986 are as follows:

Service cost		$17,200
Interest cost		31,500
Return on assets: Actual	$(61,000)	
Deferred	22,600	(38,400)
Net amortization and deferral		(9,200)
Net periodic pension cost for the year		$ 1,100

At January 1, 1985, the actuarial present value of accumulated plan benefits, using an assumed rate of return of 8%, was $317,100 ($299,000 vested) and net assets available for benefits was $354,600.

The Company also administers certain defined contribution plans for eligible employees. The cost of these plans for 1986, 1985 and 1984 was $9,700, $8,700 and $8,000, respectively.

The Company participates in various multi-employer plans for substantially all union employees. Benefits are generally based on a fixed amount for each year of service. Contributions and expense for 1986, 1985 and 1984 were $93,200, $88,700 and $90,100, respectively. Information on the actuarial present value of accumulated plan benefits and net assets available for benefits relating to the multi-employer plans is not available.

Quarterly Data (Unaudited)

(In thousands of dollars, except per share amounts)
(1985 restated for discontinued operations and the 1986 2-for-1 stock split)

1986		QUARTER FIRST (12 weeks)	SECOND (12 weeks)	THIRD (16 weeks)	FOURTH (13 weeks)	TOTAL YEAR (53 weeks)
Sales from continuing operations	$	**3,856,990**	**3,960,900**	**4,928,371**	**4,376,257**	**17,122,518**
Merchandise costs	$	**2,961,031**	**3,030,192**	**3,788,960**	**3,390,728**	**13,170,911**
Earnings (loss) from continuing operations	$	**28,584**	**47,675**	**(39,426)**	**18,935**	**55,768**
Results of discontinued operations	$	**3,687**	**3,865**	**(11,827)**		**(4,275)**
Net earnings (loss)	$	**32,271**	**51,540**	**(51,253)**	**18,935**	**51,493**
Earnings (loss) per common share						
Continuing operations	$	**.33**	**.54**	**(.47)**	**.20**	**.60**
Discontinued operations	$	**.04**	**.05**	**(.14)**		**(.05)**
Net earnings	$	**.37**	**.59**	**(.61)**	**.20**	**.55**

1985		QUARTER FIRST (12 weeks)	SECOND (12 weeks)	THIRD (16 weeks)	FOURTH (12 weeks)	TOTAL YEAR (52 weeks)
Sales from continuing operations	$	3,622,403	3,746,315	4,700,099	3,897,803	15,966,620
Merchandise costs	$	2,793,499	2,874,783	3,618,926	2,995,074	12,282,282
Earnings from continuing operations	$	28,561	42,132	41,946	46,924	159,563
Results of discontinued operations	$	2,829	4,594	3,099	10,665	21,187
Net earnings	$	31,390	46,726	45,045	57,589	180,750
Earnings per common share						
Continuing operations	$	.32	.48	.47	.54	1.81
Discontinued operations	$	.03	.06	.03	.12	.24
Net earnings	$	.35	.54	.50	.66	2.05

The results of discontinued operations (drug stores) for the fourth quarter, 1986 will be included in the determination of gain or loss on disposal. The results of the disposition will be recorded in the first quarter, 1987. Earnings from continuing operations decreased $82.3 million (95¢ per share) in the third quarter, 1986, due to the special charge for corporate restructuring. Fourth quarter, 1986 continuing operations reflect a LIFO charge of $5.3 million (6¢ per share) compared with a $6.2 million credit (7¢ per share) in the fourth quarter, 1985. Fourth quarter, 1986 earnings from continuing operations were reduced by $10.0 million (12¢ per share) to establish a charitable foundation, and approximately $8.6 million (10¢ per share) from the recapture of investment tax credits accumulated in the first three quarters of 1986. Earnings from continuing operations decreased $4.0 million (5¢ per share) in the fourth quarter, 1985 due to expenses related to store closings.

	Common Stock Price Range 1986		1985	
Quarter	**High**	**Low**	High	Low
1st	**24¼**	**21⅜**	20½	19
2nd	**27¼**	**22¾**	22⅝	19⅞
3rd	**32⅞**	**25⅞**	23	20⅝
4th	**35**	**28⅝**	25	21¼

	Dividends Paid Per Share of Common Stock	
Date Paid	**1986**	1985
March 1	**$.25**	$.25
June 1	**.25**	.25
September 1	**.26¼**	.25
December 1	**.26¼**	.25

TEN YEAR SUMMARY

(Amounts prior to 1986 restated for discontinued operations)

	1986(b)	1985	1984
OPERATIONS (In thousands of dollars, except per common share amounts)			
Sales, continuing operations	**$17,122,518**	15,966,620	15,063,414
Earnings from continuing operations before taxes based on income	**$ 95,614**	276,981	239,580
Taxes based on income	**$ 39,846**	117,418	96,382
Earnings from continuing operations	**$ 55,768**	159,563	143,198
Per common share(a)			
Earnings from continuing operations	**$ .60**	1.81	1.59
Dividends on common stock	**$ 1.025**	1.00	1.00
BALANCE SHEET STATISTICS (In thousands of dollars, except per common share amounts)			
Inventories	**$ 1,197,238**	1,472,756	1,245,985
Working capital	**$ 177,723**	273,672	276,522
Property, plant and equipment, net	**$ 1,968,472**	1,936,921	1,846,436
Total assets	**$ 4,076,447**	4,177,807	3,687,326
Long-term debt	**$ 561,258**	710,890	577,842
Obligations under capital leases	**$ 196,981**	214,586	200,815
Shareowners' equity	**$ 1,154,771**	1,188,670	1,148,776
Per common share(a)	**$ 12.25**	13.61	12.74
OTHER STATISTICS (In thousands of dollars, except stock prices)			
Cash provided from operations	**$ 441,446**	392,305	380,743
Capital expenditures	**$ 474,627**	362,436	310,029
Rent	**$ 226,070**	202,121	195,774
Interest expense	**$ 103,765**	101,862	95,618
Common stock price range (a)	**$ 21⅜-35**	19-25	14⅝-19¾
RETAIL FACILITIES (Areas in thousands of square feet)			
Stores — end of year			
Food stores	**1,298**	1,367	1,318
Convenience stores	**735**	643	443
Total square feet — end of year			
Food stores	**45,054**	45,751	43,939
Convenience stores	**1,786**	1,527	1,057

(a) In 1986, the Company declared a two-for-one stock split. All share and per share amounts have been restated to reflect this split.

(b) 1980 and 1986 were fifty-three week years.

(c) In 1979, the Company changed from the First-In, First-Out (FIFO) method of valuing certain of its inventories to the Last-In, First-Out (LIFO) method.

1983	1982	1981	1980(b)	1979(c)	1978	1977
14,446,823	14,045,270	13,275,039	11,981,245	10,370,722	8,953,032	7,597,646
185,679	276,356	274,654	206,658	180,394	187,489	142,060
72,002	95,109	102,916	78,796	71,997	82,719	63,002
113,677	181,247	171,738	127,862	108,397	104,770	79,058
1.24	1.91	1.87	1.45	1.23	1.20	.91
.955	.88	.785	.70	.63	.445	.38
1,151,131	1,108,786	951,773	900,095	896,147	796,183	703,358
339,701	368,266	405,065	246,011	271,211	320,461	311,844
1,769,339	1,610,693	1,339,626	1,138,287	962,018	814,377	728,186
3,529,813	3,319,699	2,964,017	2,483,504	2,232,134	2,023,767	1,843,236
665,386	604,007	477,501	311,036	269,026	239,172	247,060
212,406	194,195	187,516	173,268	169,561	165,856	153,958
1,072,852	1,086,345	1,000,049	835,066	762,194	692,894	611,169
11.99	11.65	10.67	9.42	8.63	7.91	7.06
365,139	299,232	423,566	362,986	174,008	217,170	176,947
368,895	464,380	324,280	298,766	242,324	168,543	127,944
187,134	169,712	144,262	129,994	110,966	96,203	82,555
89,110	69,815	55,358	44,044	36,408	35,879	36,912
16⅞-21½	11¾-23⅝	9⅝-14	7-11⅞	8¾-13½	6⅜-9¼	5⅞-7¼
1,428	1,418	1,475	1,459	1,438	1,406	1,384
352	352	349	333	326	290	189
46,077	44,088	43,615	40,846	38,341	36,113	33,729
809	807	800	732	718	638	400

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Chairman of the Board
Dillon Companies, Inc.

Richard W. Dillon
Vice Chairman of the Board
Dillon Companies, Inc.

Walter R. Dryden
Senior Vice President

Donald F. Dufek
Group Vice President

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Chief Executive Officer

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William J. Sinkula
Group Vice President and Secretary

Lawrence M. Turner
Vice President and Treasurer

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and former Chairman of the Board
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The Kroger Co.

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Indiana University

Otis M. Smith [1,3]
Of Counsel
Lewis, White & Clay

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[1] Audit
[2] Compensation
[3] Corporate Responsibility
[4] Executive
[5] Financial Policy
[6] Nominating
[7] Pension Plans

KROGER STOCK OWNERSHIP PLANS

To benefit its employees and the general shareowner population Kroger has established a variety of stock ownership plans. These plans are administered by several different institutions for different constituencies. To facilitate inquiries, these plans are described below.

General Shareowners

If you have a stock certificate in your possession and have questions about dividends, changes of address, 1099's, etc. contact:

MORGAN SHAREHOLDER SERVICES TRUST CO.
TRANSFER AGENT AND REGISTRAR
30 BROADWAY
NEW YORK, NY
10007-2192

1-212-587-6733

Dividend Reinvestment and Stock Purchase Plan

If you want your dividends reinvested or wish to make additional purchases of stock contact:

MORGAN SHAREHOLDER SERVICES TRUST CO.
30 BROADWAY
NEW YORK, NY
10007-2192

Kroger Stock Exchange

A voluntary monthly payroll deduction plan for employees of Kroger and all subsidiary companies. If you have questions or wish to sell stock you have purchased through this plan contact:

THE FIRST NATIONAL BANK OF CINCINNATI
P. O. BOX 1118
CINCINNATI, OHIO
45201
ATTN. CHRIS POPPE

IN CINCINNATI CALL:
632-4397
IN OHIO:
1-800-346-7500
OUTSIDE OHIO:
1-800-354-0400

ESOP

Kroger common stock held in an ESOP trust for individual employees who have met the eligibility requirements to become participants. If you have questions concerning the ESOP, contact your local personnel manager.

401-K Plan

This plan allows eligible employees to defer compensation on a pre-tax basis. Funds can be deferred into one or more investment funds which include a fund holding Kroger stock. The Company provides a match on the Kroger stock and a profit match on all investment funds based on the total increase in Company pre-tax profit. For more information employees should contact their local personnel manager.

Form 10-K

A copy of the Company's 1986 report to the Securities and Exchange Commission, Form 10-K, is available to shareowners on request by writing: Lawrence M. Turner, Treasurer, The Kroger Co., 1014 Vine Street, Cincinnati, Ohio 45202-1119.

Annual Meeting

The annual meeting of shareowners will be held at The Albert B. Sabin Convention Center, 525 Elm St., Cincinnati, Ohio on May 15, 1987, at 10 a.m.

Independent Certified Public Accountants

Coopers & Lybrand
1500 Atrium One
201 East Fourth Street
Cincinnati, Ohio 45202

Shareowners

At the end of 1986, a total of 59,745 shareowners of record owned 84,063,921 shares of The Kroger Co. common stock.

Common Stock

The main trading market for The Kroger Co.'s common stock is the New York Stock Exchange, where it is listed under the symbol KR.

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The Kroger Co. · 1014 Vine Street · Cincinnati, Ohio 45201 · (513) 762-4000